Economic Activity

We reduced Brazil GDP growth forecast to 1.7% from 2.3% in 2022

Rodolfo Margato
Economist

Highlights

Brazil's GDP remained virtually flat in Q2, falling short of expectations. We expect GDP to resume growth throughout the second half of 2021, driven mostly by the rebound of services rendered to families and the normalization of public services.

Nonetheless, the lower statistical carryover implied by Q2 figures led us to revise our projection for 2021 GDP growth, to 5.3% from 5.5%.

More importantly, we highlight mounting economic headwinds ahead, looking into 2022. First, increased fiscal risk perception and political uncertainty worsened financial conditions substantially in recent weeks. Second, the impacts of the ongoing water crisis (and subsequent rise in electricity tariff) adds downward pressure on economic output.

In this context, we now see lower GDP growth for 2022 - to 1.7% from 2.3%.

We note that the baseline scenario does not incorporate electricity rationing (i.e., forced reduction of consumption), which could push 2022 GDP growth even further. The persistence of inflationary pressure and sluggish growth abroad also represent potential risks to our baseline scenario.

Q2 GDP growth falls short of expectations

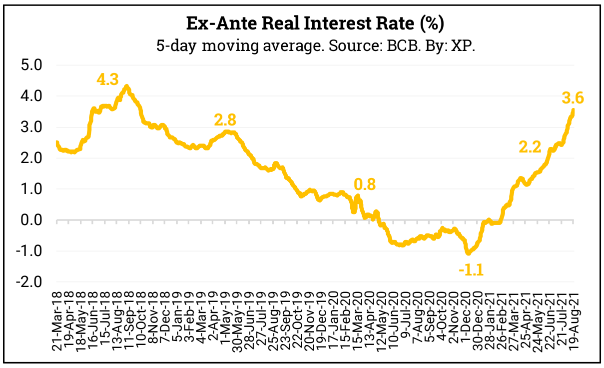
Brazil's GDP remained virtually flat in Q2 (-0.05% QoQ; 12.4% YoY), below our expectation (0.3% QoQ; 13.0% YoY) and market consensus (0.2% QoQ; 12.8% YoY). On the supply side, the positive highlight was the widespread expansion in the services sector - although at a slower-than-expected pace - on the back of greater vaccination and improved mobility. On the other hand, Agriculture & Livestock GDP and total Industry GDP registered poor performance in Q2. Rising input costs and scarce supply represent key challenges for manufacturing (as seen mostly in the automotive industry) – a trend that should not be reversed soon.

On the demand side, Exports registered a substantial increase in Q2, driven by strong global economic recovery. Conversely, household spending remained stable, impacted by high inflation and still depressed aggregate wages. Looking ahead, we still see Brazil's GDP resuming the upward path throughout the second half of 2021, driven mostly by the rebound of services rendered to families and gradual normalization of public services. On this, we expect GDP to expand by 0.8% QoQ in Q3. That said, **the lower statistical carryover effect implied by Q2 figures (including details from GDP breakdown) led us to revise our projection for 2021 GDP growth to 5.3% from 5.5%.**

Mounting Economic Headwinds

More importantly, we highlight mounting economic headwinds ahead, looking into 2022. First, increased fiscal risk perception and political uncertainty worsened financial conditions substantially in recent weeks. Ex-ante real interest rates jumped from 2.2% in late June to 3.6% to now.

In our baseline scenario, we anticipated real interest rates reaching 3% early next year. If current market conditions persist, these could reach 5% in January. **While expecting some decompression in the coming months, real interest rates should stand at levels higher than we anticipated.**



Additionally, the impacts of the ongoing water crisis (and subsequent rise in electricity tariff) adds downward pressure on economic output. The impacts are felt through lower real disposable household income, higher costs in industrial activities and more challenging agricultural production.

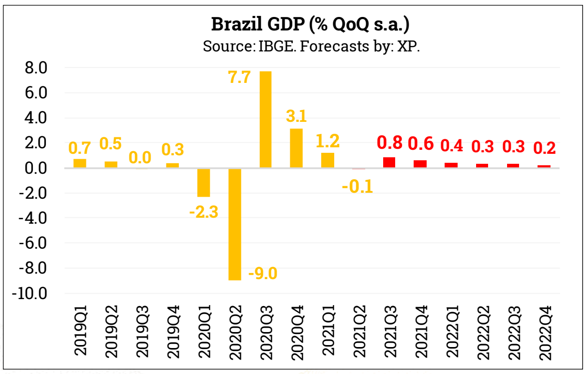
Considering the deterioration in financial conditions, water crisis and lower statistical carryover effect from 2021 GDP growth (minor impact of -0.1pp), **we are also revising our expectation for 2022 GDP growth, to 1.7% from 2.3%.**

Our baseline scenario does not incorporate electricity rationing (i.e., forced reduction of consumption), but we understand the increased likelihood of this alternative scenario. **If this materializes, 2022 GDP growth would be revised even further.**

Other risks to domestic economic growth remain on the radar. On this, we note the persistence of inflationary pressure (potentially implying a tighter-than-expected monetary policy) and potentially lasting sluggish global economic growth, on the back of increasing risks linked to the Covid-19 Delta variant.

GDP Breakdown (annual change - %)	2020	2021 (F)	2022 (F)
Agriculture and Livestock	2.0	2.1	1.8
Industry	-3.5	6.0	1.4
Services	-4.5	5.1	1.9
Total GDP	-4.1	**5.3**	**1.7**
Household Consumption	-5.5	3.9	1.6
Government Consumption	-4.7	1.5	1.3
Gross Fixed Capital Formation	-0.8	13.7	2.0
Exports	-1.8	9.0	2.4
Imports (-)	-10.0	12.2	1.5

Source: IBGE. Forecasts by: XP.



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